Stranded Gas Hearings

(0406171315 Minutes)

How Will Your Company Build Up a Pipeline Tariff? (e.g., debt/equity ratio, period and method of depreciation, treatment of cost overruns)

Optional Appearances by All Entities Interested in Building an Alaska Natural Gas Pipeline
Tony Palmer, Vice President, Alaska Business Development, TransCanada, June 17, 2004.

MR. TONY PALMER, Vice President, Alaska Business Development, TransCanada Pipelines, Ltd., prefaced his remarks saying he wouldn't address specifics on how he would structure a tariff.

There are a number of different methodologies used to create gas pipeline tariffs in the United States and Canada. My testimony will focus primarily on a cost-of-service methodology, which is the traditional form for a new long pipeline system with high risks, as this project will see. At the end of my testimony I will discuss a couple of alternatives that could be utilized for a project such as the Alaska gas pipeline.

The initial pipeline from Alaska can be expected to remain regulated by U.S. and Canadian governments. It will be highly capital intensive with route-specific investments that cannot readily be redirected to serve other purposes. Once you lay that steel in the ground, it's very difficult to move it to provide another service. The inherent business risks for a pipeline include development risk, construction completion risk, reserve, credit, operating, etc.... The pipeline will be a contract carrier; that is standard in the gas business.... The regulators in the United States and Canada – FERC in the United States, the National Energy Board in Canada - for commercial matters that determine the types and levels of tariffs, which a pipeline may charge its customers for the services it provides and also the terms and conditions of service. The approved tariffs and terms and conditions attempt to balance the interests of shippers, consumers, other stakeholders and the pipeline investors. It's intended to be a fine balance of interests.

The terms and conditions of service are an integral part of the tariff and must be considered in conjunction with the tariff. Natural gas pipelines are highly leveraged businesses with significant financial risk and lower business risk than many other large corporations. That's the structure. Pipeline companies generally have higher financial risk because they are highly leveraged and they have lower business risk and that enables them to take on the additional debt. That's the fundamental structure that is the foundation for most pipeline projects.

The Alaska gas pipeline can be expected to commence operations with a high debt ratio in order to minimize the pipeline tariff. You heard testimony yesterday from J.P. Morgan. They gave you some evidence as to how that variation can change the pipeline structure, but the fundamental business risk must be matched with the leverage on the pipe – the debt equity ratio - as well as the returns.

So, the high debt ratio will require a properly secured contract with low business risk for the pipeline. The proposed U.S. energy bill provisions for the Alaska project stipulate that the U.S. government may provide loan guarantees [for] up to 80 percent of the capital costs of the project. Such a loan guarantee would assist the pipeline owners in obtaining the multibillions in debt financing and improve the interest rate and loan terms to the benefit of all project stakeholders. In order to obtain the financing, the pipeline must demonstrate the ability to make payments on its debt, both principle and interest, generally through long-term shipping commitments from credit-worthy customers and by meeting certain debt service coverage covenants and other loan conditions.

MR. PALMER showed the committee a schematic of the equity investment that goes into a project of this scale. It demonstrated that risk capital is advanced by equity investors early in the project and before the debt is invested.

So, the current investment that my company has, as well as others, in this project is 100 percent equity. There is no debt behind the project during the development phase; it is 100 percent equity

– all risk capital. Even during construction, that also is a period where you have equity capital. If you have contractual terms resolved at that point, you can start to advance your debt during the construction phase.

Recovery of the equity comes over the life of the project and while he used 20 years for his illustration, it's typically spread over the life of a contract.

Most new pipes in North America have been structured on a cost-of-service basis and a cost-of-service methodology allows the pipe company to recover all prudently incurred costs for providing transportation service including a fair return on capital investment. This usually results in an efficient use of capital with the lowest possible tariffs. These low tariffs, however, are achieved by minimizing the business risks to the pipeline company. The tariffs are subject to full discovery and are completely transparent to all stakeholders for each component of the cost of service. That cost of service model allows the pipe company to recover its fixed costs in a demand charge to its customers – in other words, unrelated to the actual volumes transported on any particular day....

The variable costs are recovered through a commodity charge, which is related to the actual volumes. His schematic addressed property and income taxes and depreciation rate. The depreciation rate is often a factor that is used on a project of this scale to adjust the variability of the tariff over time. It normally reflects the economic life of the pipeline and allows the recovery of capital, both equity and debt, invested in the pipeline over that life. The traditional model had depreciation rates established on a straight-line basis collecting an even amount of depreciation over the life of the project.

For large new pipelines that need to compete in the marketplace with existing infrastructure, depreciation rates are sometimes modified to levelize the tariff. This means a lower collection of depreciation in the early years of the project and a higher collection in the later years, much like a residential mortgage schedule for principle repayment.... This method, of course, increases the risk for a pipeline company. Instead of getting an even recovery, an early recovery of your capital, you're moving that to the back. That increases risk. There are a number of other methodologies that have been used over the years instead of cost-of-service for gas pipelines.

MR. PALMER said forms of incentive regulation have been used that apply some degree of sharing between shippers and pipeline owners for both capital costs, operating costs and, occasionally, debt costs.

Other forms of negotiated rates include a fixed toll model with some or all of the components of cost-of-service fixed for the shipper for some period of time. This methodology provides toll certainty for the customer, but significantly increases the risk for the pipeline company. Changes in inflation, interest rates, equity returns for investments of similar risks, capital cost overruns, operating tax variations in a fixed toll model may not be fully passed through to the customer as would be the case for the cost-of-service methodology. There are definitely merits to different tariff methodologies that can be considered for the Alaska gas pipeline by project stakeholders. A traditional cost-of-service methodology with terms negotiated between the pipe company and the shippers and ultimately approved by regulators will usually result in the lowest tariff over the life of the project as it should have the lowest business risk for the pipeline company, assuming solid transportation contracts with strong credit-worthy customers. However, this methodology increases the risk allocation for the shipper and may not provide the highest value to the shipper. If actual costs differ from estimated costs, then all these changes will be fully borne by the customer in the cost-of-service methodology. That's the way it works. For example, you have current interest rates at extremely low levels. You heard testimony to that effect yesterday from J.P. Morgan. An estimated cost-of-service tariff today would likely use those low interest rates. If the actual interest rates are several percentage points higher at the time the pipeline were actually financed, cost-of-service methodology would insure that 100 percent of those increased costs would be passed through to the customer in their tariff and it works the other way, as well. If interest rates fall, that's a pass-through to the customer. That's not a risk the pipeline company bears in a cost-of-service methodology.... You would have an estimation based on interest rates,

inflation and other components. The actuals will be what will show up in people's tariffs. A fixed toll model or other incentive mechanisms shift some or all of the inflation, interest rate return and equity, operating costs, capital costs and capital cost recovery onto the pipeline company. Capital recovery shifts can imply the pipeline is bearing gas reserves risk in the case where proven gas reserves are insufficient to fill the pipeline beyond the contract term. That may be a risk that the shippers want to bear and it may be a risk that they want the pipeline to bear or some sharing of that risk. This shifting of risk could be beneficial to a shipper that cannot or will not bear the risks inherent in a cost-of-service tariff. A fixed tariff with commensurate lower risks can provide higher value to some shippers despite a higher nominal tariff than would be applied with a cost-of-service methodology.

I'll give you an example in ordinary life – is some of us choose to sign up for a 30-year residential mortgage because we want to know that the price of that interest rate over the life of that mortgage. Others of us choose to go for six-month mortgages. Generally, the six-month mortgage has a lower interest rate. Which is better? Well, it depends on your circumstances and which suits your pistol, in effect, as to how you would like to structure your business. It's not that one is better than the other. Some parties will prefer one and some parties will prefer another. We would suggest that the shippers and pipeline companies and other stakeholders will negotiate the methodology that is best for all parties. North American regulators have been cooperative in recent years in approving negotiated methodologies if sophisticated parties have negotiated arrangements on both sides. So, if you have independent pipeline companies negotiating with sophisticate shippers or other stakeholders, regulators have generally been cooperative in approving those. Transcanada has significant experience in cost-of-service models as well as negotiated or other incentive models and we're ready to negotiate with shippers and other stakeholders on the tariff model which best suites the project, which provides a reasonable reward commensurate with risk for the pipeline and a clear regulatory path to an early in-service date. If customers and other stakeholders want a cost-of-service methodology, that's just fine with our company. If they prefer other alternatives that will shift some risks assuming that there's a balance of risk and reward, we're happy to negotiate on those, as well.